

**Office of Chief Counsel
Internal Revenue Service
Memorandum**

Number: **200901032**

Release Date: 1/2/2009

CC:ITA:B02:RMKelley
POSTN-128622-08

Third Party Communication: None
Date of Communication: Not Applicable

UILC: 451.13-00

date: September 24, 2008

to: Area Counsel (Area 1)
(Small Business/Self-Employed)

from: Thomas D. Moffitt
Branch Chief, Branch 2
(Income Tax & Accounting)

subject: Timing of income inclusion

This Chief Counsel Advice responds to your request for assistance dated June 26, 2008. This advice may not be used or cited as precedent.

LEGEND

Taxpayer =
Product =
Year 1 =
Year 2 =

ISSUES

- (1) When are payments Taxpayer receives for sales of Product included in Taxpayer's gross income under § 451 of the Internal Revenue Code?
- (2) May the Taxpayer use the deferral method of § 1.451-5 of the Income Tax Regulations for the payments?
- (3) May the Taxpayer use the deferral method of Rev. Proc. 2004-34, 2004-22 I.R.B. 991, for the payments?

CONCLUSIONS

- (1) Taxpayer is required to include the payments in gross income in the taxable year the payments are received under § 451.
- (2) Taxpayer's method of accounting is a proper method under § 1.451-5 only if Taxpayer has substantially complied with the information schedule requirement of § 1.451-5(d).
- (3) Taxpayer's method of accounting is a proper method under Rev. Proc. 2004-34 only if Taxpayer properly adopted or changed to the method under section 8 of the revenue procedure.

FACTS

Taxpayer is in the business of selling and delivering Product to customers. Taxpayer offers its customers different payment options, two of which are at issue here. In the first option, the customer makes a single lump sum payment in advance for the entire estimated amount of Product deliveries for the season. In the second option, referred to as "budget billing", the customer agrees to make equal installment payments over the course of the season. For each option, the customer agrees to a fixed rate for each unit of Product, thereby protecting the customer from price fluctuations throughout the season. When a delivery is made, Taxpayer deducts a payment amount from the balance of the customer's account for the volume delivered. If a balance remains in a customer's account at the end of the season, Taxpayer retains the funds and applies them to the customer's account for the following season. While Taxpayer routinely refunds balances remaining in customer accounts upon request to maintain good customer relations, the contracts with the customers provide that Taxpayer is entitled to retain the funds and apply the funds only to future purchases.

Under Taxpayer's current method of accounting, Taxpayer includes in gross income in the taxable year of receipt the portions of the lump sum and periodic payments attributable to Product delivered in that taxable year. Taxpayer includes the remaining portions of the payments in the succeeding taxable year. Taxpayer does not have an applicable financial statement, as defined in section 4.06 of Rev. Proc. 2004-34. Taxpayer currently is under examination with respect to Year 1 and Year 2.

LAW AND ANALYSIS

ISSUE (1)

A taxpayer generally must include an amount in gross income for the taxable year in which received by the taxpayer, unless, under the method of accounting the taxpayer uses in computing taxable income, the amount is properly accounted for in a different period. § 451(a). Under an accrual method of accounting, income is included in gross income when all the events have occurred that fix the right to receive the income and

the amount thereof can be determined with reasonable accuracy. § 1.451-1(a) of the Income Tax Regulations. All the events that fix the right to receive income occur when (1) the required performance takes place, (2) payment is due, or (3) payment is received, whichever happens earliest. See *Schlude v. Commissioner*, 372 U.S. 128 (1963); *American Automobile Assn. v. United States*, 367 U.S. 687 (1961); *Automobile Club of Michigan v. Commissioner*, 353 U.S. 203 (1957). Thus, when a taxpayer receives a payment for goods or services from a customer that is includible in the taxpayer's gross income, the taxpayer generally is required to include the payment in income upon receipt, even where the goods or services are to be provided in a future taxable year. § 1.451-1(a); *Schlude v. Commissioner*, *supra*.

Taxpayer has argued that its deferral of the income was proper under § 451, citing as authority *Artnell Co. v. Commissioner*, 400 F.2d 981 (7th Cir. 1968). In *Artnell*, the court allowed a professional baseball franchise to defer advance payments for season tickets, radio and television rights, and season parking passes for games to be played in the following taxable year. The court distinguished the trilogy of Supreme Court cases of *Schlude*, *supra*, *American Automobile Assn*, *supra*, and *Automobile Club of Michigan*, *supra*, on the grounds that in those cases the time and extent of the performance of future services were uncertain. The court noted that income received by the sports franchise was allocable to games to be played on a fixed schedule.

Artnell is distinguishable from the present case because Taxpayer's delivery of Product throughout the season is not analogous to the fixed dates of performance inherent in the schedule of a professional baseball franchise. Thus, unless Taxpayer properly uses one of the two deferral methods described below, in order to clearly reflect income Taxpayer must include the entire amount of the lump sum payments and the periodic payments in gross income upon receipt.

ISSUE (2)

The first deferral method is found in § 1.451-5 (the regulation). In general, the regulation allows a taxpayer to adopt or change to a method of accounting with respect to advance payments for sales of goods and services integral to those goods. § 1.451-5(a)(1) and (2). If a taxpayer meets all of the applicable requirements, the regulation permits the taxpayer to defer the inclusion in gross income of the advance payments beyond the taxable year of receipt. § 1.451-5(b)(1)(ii). In the case of sales of inventoriable goods, this deferral generally is limited to the second taxable year following the year substantial advance payments are received. § 1.451-5(c). The regulation also requires a taxpayer using this deferral method to attach an information schedule to its income tax return in each taxable year. § 1.451-5(d).

From the facts that you have provided, it appears that Taxpayer's current method of accounting meets the requirements of § 1.451-5(a), (b), and (c). However, more facts need to be developed to determine whether Taxpayer has substantially complied with the information schedule requirement of § 1.451-5(d). If it is determined that Taxpayer

has substantially complied with this requirement, then Taxpayer is using a proper method of accounting. If Taxpayer has not substantially complied with this requirement, then Taxpayer is not using a proper method of accounting, and it is within the Commissioner's discretion to require Taxpayer to include the payments in income upon receipt in accordance with § 451. If this is the case, Taxpayer would be required to file a Form 3115, Application for Change in Accounting Method, in order to obtain consent to change to the deferral method for future taxable years.

ISSUE (3)

The second deferral method is found in Rev. Proc. 2004-34, 2004-22, I.R.B. 991 (the revenue procedure). The revenue procedure permits a taxpayer to defer the inclusion in gross income of advance payments, as defined in the revenue procedure to include payments for services and for the sale of goods. Secs. 4.01 and 5.02 of Rev. Proc. 2004-34. Subject to restrictions that do not appear to be applicable in this case, a taxpayer who does not have an applicable financial statement generally must include an advance payment in gross income in the taxable year of receipt to the extent earned in that year, and the taxpayer must include the remaining amount in gross income in the succeeding taxable year. Sec. 5.02(3)(b) of Rev. Proc. 2004-34.

The exclusive administrative procedures under which a taxpayer within the scope of the revenue procedure may obtain consent to change to this deferral method are outlined in section 8 of the revenue procedure. In general, a taxpayer may adopt this deferral method for advance payments in the first taxable year in which the taxpayer receives advance payments. A taxpayer wishing to change to this deferral method generally must file a Form 3115, Application for Change in Accounting Method, using the automatic or advance consent procedures, as applicable.

The deferral method available to taxpayers in Rev. Proc. 2004-34 is a separate and distinct method from the deferral method available in § 1.451-5. The two methods are not mutually exclusive and one or both methods may be available with respect to an individual item. Sec. 1 of Rev. Proc. 2004-34; see *also* Announcement 2004-48, 2004-22 I.R.B. 998.

From the facts that you have provided, it appears that Taxpayer's current method of accounting meets the substantive requirements for the deferral method of section 5.02 of the revenue procedure. However, because the years under examination are Year 1 and Year 2 (the revenue procedure was issued in 2004), and the facts do not indicate that Taxpayer filed a Form 3115 to change to this deferral method, it appears that Taxpayer did not properly adopt or change to this method of accounting. If Taxpayer cannot show that it did properly adopt or change to this method under the provisions of section 8 of the revenue procedure, Taxpayer is not using a proper method of accounting. It would then be within the Commissioner's discretion to require Taxpayer to include the payments in income upon receipt in accordance with

§ 451, and Taxpayer would be required to follow the provisions in the revenue procedure in order to obtain consent to change to this deferral method for future taxable years.

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Please call (202) 622-7900 if you have any further questions.